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Message Text

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PRS-01 CIAE-00 COME-00 FRB-03 INR-07 NSAE-00 USIA-06

XMB-02 OPIC-03 LAB-04 SIL-01 AGR-05 /092 W
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TO SECSTATE WASHDC 2615
INFO AMEMBASSY LONDON
AMEMBASSY PARIS
AMEMBASSY ROME
USMISSION OECD PARIS
USMISSION EC BRUSSELS
AMCONSUL BREMEN
AMCONSUL DUSSELDORF
AMCONSUL FRANKFURT
AMCONSUL HAMBURG
AMCONSUL MUNICH
AMCONSUL STUTTGART
USMISSION USBERLIN

C O N F I D E N T I A L SECTION 01 OF 03 BONN 14475

DEPARTMENT PASS TREASURY AND FRB

E.O. 11652: GDS
TAGS: EFIN, GW
SUBJECT: REACTION TO NEW GOVERNMENT ECONOMIC/FISCAL
POLICY MIXED AT BEST

REF: BONN 14111, BONN 14205, BONN 14307

1. SUMMARY. AS MIGHT HAVE BEEN EXPECTED, THE
GOVERNMENT'S NEW ECONOMIC/FISCAL POLICY MEASURES HAVE
NOT RECEIVED UNIVERSAL ACCLAIM. IT IS BECOMING RAPIDLY
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APPARENT THAT THE PRINCIPAL DEVICE FOR REDUCING THE

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DEFICIT IS IN THE FORM OF INCREASED TAXES. THE ECONOMY MEASURES STEP ON SOME TOES BUT NOT A SUFFICIENTLY LARGE NUMBER OF THEM AS TO PUT THIS ASPECT OF THE PROGRAM IN TROUBLE. SOME, IN FACT, WOULD RATHER THE CUTS WERE EVEN MORE DRASTIC. IT IS THE INCREASE IN THE ADDED-VALUE TAX BY 2 PERCENT BEGINNING IN 1977 THAT HAS DRAWN THE MOST CRITICISM. A RISE IN THE EMPLOYER/EMPLOYEE CONTRIBUTION TO THE UNEMPLOYMENT INSURANCE SYSTEM ALSO HAS COME UNDER ATTACK. LABOR IS CONCERNED AND HAS RESERVED ITS POSITION. BUSINESS IS UNHAPPY ALSO. THE OPPOSITION IS MAKING SOUNDS THAT COULD SIGNIFY THAT PARLIAMENTARY APPROVAL OF THE TAX INCREASE MAY NOT BE FORTHCOMING. WHILE THE STEP WAS REGARDED AS INEVITABLE IN THE LONG RUN GIVEN THE FISCAL STRUCTURE, THE TIMING OF THE ANNOUNCEMENT SEEMS, AT FIRST GLANCE, POLITICALLY INAPPROPRIATE. REGARDLESS OF WHAT HAPPENS TO THE PROGRAM, THE COALITION WILL BE ABLE TO DEPICT ITSELF AS A SUPPORTER OF RESPONSIBLE FISCAL POLICY.
END SUMMARY.

2. THE NEW GOVERNMENT ECONOMIC/FISCAL POLICY MEASURES THAT HAVE EVOLVED IN THE LAST FEW WEEKS MAY BE SUMMARIZED AS INCLUDING, IN ADDITION TO THE ECONOMIC STIMULATION PROGRAM OF DM 5.75 BILLION, AN "ECONOMY" BUDGET, AN INCREASE IN THE VALUE ADDED TAX (VAT), AND AN UPPING OF THE EMPLOYER/EMPLOYEE CONTRIBUTIONS TO THE UNEMPLOYMENT INSURANCE SCHEME. CONSIDERING THE LAST THREE ELEMENTS (SEE REFS FOR THE STIMULATION PROGRAM), IT IS PROBABLY THE ECONOMY OR AUSTERITY APPROACH TO BUDGET REQUESTS FOR 1976 THAT HAVE BEEN LEAST CRITICIZED. THIS IS NOT TO SAY THAT THIS ASPECT HAS ESCAPED ALL CRITICISM EITHER, BECAUSE THE CIVIL SERVANTS, WHO ARE THE ONES MOST SEVERELY AFFECTED, HAVE PROTESTED THROUGH THEIR UNION CHIEF THAT THEY ARE BEARING THE BRUNT IN THE BUDGET CUTBACKS. OF THE CLAIMED DM 2.5 BILLION BUDGETARY SAVINGS PROJECTED FOR 1976, THE CIVIL SERVANTS ACCOUNT FOR AT LEAST 50 PERCENT. THEIR (WELL-SHOD) TOES HAVING BEEN STEPPED ON THE HEAVIEST THEY ARE THE ONES COMPLAINING THE LOUDEST. THIS, THOUGH, IT NOT EXPECTED TO BE A CONFIDENTIAL

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MAJOR PROBLEM IN OBTAINING APPROVAL OF WHAT IS, OF COURSE, STILL ONLY A PROPOSED BUDGET FOR NEXT YEAR. MORE FREQUENTLY HEARD IS CRITICISM THAT THE BUDGET CUTBACKS HAVE NOT REALLY BEEN SUFFICIENTLY DEEP AND THAT THE REAL BURDEN FOR REDUCING THE DEFICIT HAS FALLEN MUCH MORE HEAVILY TO THE SIDE OF INCREASING REVENUES.

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3. THE MAJOR ELEMENT IN REDUCING THE PROJECTED 1976 BUDGET IS A PROPOSED INCREASE IN THE CONTRIBUTIONS TO THE UNEMPLOYMENT INSURANCE SCHEME BY 1 PERCENT, TO BE SHARED EQUALLY BY EMPLOYER AND EMPLOYEE. THIS MEASURE IS EXPECTED TO RAISE DM 3.8 BILLION IN 1976 AND TO ACCOUNT FOR DM 4.6 BILLION REVENUE INCREASE IN 1977. THE VAT INCREASE WOULD FIRST BECOME EFFECTIVE JANUARY 1977 AND WOULD RAISE THE TAX LEVEL FROM 11 TO 13 PERCENT. THIS, ALONG WITH INCREASES IN TAXES ON TOBACCO AND ALCOHOL IS PROJECTED TO RAISE GOVERNMENT

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USMISSION EC BRUSSELS
AMCONSUL BREMEN
AMCONSUL DUSSELDORF
AMCONSUL FRANKFURT
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REVENUES BY A VERY SIGNIFICANT DM 8.1 BILLION IN ITS
FIRST YEAR OF OPERATION, AND DM 10 BILLION IN 1978.
IT IS THESE TWO REVENUE PRODUCING MEASURES THAT HAVE
STIMULATED THE MOST DEBATE AND CRITICISM. THERE IS
A QUESTION, IN FACT, AS TO WHETHER THESE TWO MEASURES
WILL BE ABLE TO OBTAIN PARLIAMENTARY APPROVAL.

4. WE HAVE BEEN TOLD BY A HIGH-RANKING FINANCE
MINISTRY OFFICIAL, WHO IS AN SPD STALWART, THAT
ALTHOUGH THERE IS MUCH DISSENSION IN THE PARTY RANKS
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OVER WHAT IS FELT TO BE AN UNFAIR BURDENING OF THE
WORKING MAN IN THE GOVERNMENT'S PROGRAM, THEY WILL
NEVERTHELESS CLOSE RANKS IN SUPPORT OF THE PROGRAM
AFTER A PROPER "EDUCATIONAL" PROGRAM WHICH IS BEING
UNDERTAKEN. HE STRESSED THAT THE SPD HAD INDEED
FORMALLY APPROVED THE PROGRAM. MOST DIFFICULT TO
PERSUADE WILL BE THE DGB, HE SAID. DGB CHIEF
HEINZ VETTER HAS ALREADY MET WITH THE CHANCELLOR ON
THIS SUBJECT (BEING REPORTED BY SEPTEL).

5. OPPOSITION LEADER KOHL REFERRED TO THE GOVERNMENT'S
PACKAGE AS A DECLARATION OF BANKRUPTCY. HE PARTICULARLY
TOOK EXCEPTION TO THE PROPOSED VAT INCREASE AND
QUESTIONED THE WISDOM OF THE RAISING OF THE EMPLOYER/
EMPLOYEE CONTRIBUTION TO THE UNEMPLOYMENT INSURANCE
SYSTEM. HE DID NOT, HOWEVER, MAKE A CLEAR STATEMENT
AS TO THE POSITION THE CDU WOULD TAKE VIS-A-VIS THE
PARLIAMENTARY APPROVAL OF THESE PROPOSALS. HOWEVER,
CDU/CSU FLOOR LEADER CARSTENS REJECTED THE CONTEMPLATED
VAT INCREASE, WHICH, OF COURSE, REQUIRES APPROVAL OF
THE OPPOSITION-CONTROLLED BUNDESRAT. GERHARD
STOLTENBERG HAS MAINTAINED A NONCOMMITTAL STANCE ON
THIS, WHICH OUR FINANCE MINISTRY FRIEND CONSIDERED A
POSITIVE SIGN. VARIOUS OTHER REPORTS INDICATE THAT
THE CDU AND CSU OPPOSITION ARE LEANING TOWARDS A
REJECTION OF THE VAT INCREASE WHEN IT COMES TO A
VOTE, THEREBY NULLIFYING THE MAJOR ELEMENT IN THE
GOVERNMENT'S PROGRAM TO CLOSE THE GAP BETWEEN REVENUES
AND EXPENDITURES IN THE MEDIUM TERM.

6. BUSINESS IS NOT TOO HAPPY EITHER WITH THE
CONTEMPLATED MEASURES. THE DIHT (CHAMBER OF COMMERCE)
FEELS THAT THE RECOURSE TO TAX INCREASES WOULD SPOIL
THE CHANCE FOR A MUCH NEEDED LIMITATION OF THE PUBLIC
SECTOR'S SHARE IN GNP. THE INCREASED BURDEN ON
BUSINESS INHERENT IN THE CONTEMPLATED RAISING OF THE

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CONTRIBUTIONS OF THE INSURANCE SYSTEM IS IN SHARP
CONTRAST TO WHAT IS REQUIRED TO KEEP INVESTMENT
FROM SHRINKING FURTHER, THE DIHT CHARGES. IT ALSO
CLAIMS THAT THE LOW FORECASTED RATE OF INCREASE IN
THE GROWTH OF FEDERAL OUTLAYS IS ILLUSORY.
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7. FARM LEADERS HAVE TAKEN EXCEPTION TO THE CONTEMPLATED
CURTAILMENT OF FARM SUBSIDIES BY SOME DM 270 MILLION
IN 1976 AND RISING AMOUNTS IN SUBSEQUENT YEARS.

8. OUR WELL-CONNECTED FINANCE MINISTRY CONTACT STATED
THAT THE FDP HAD SOUGHT TO INCLUDE IN THE PACKAGE OF
MEASURES A REDUCTION IN TAXATION FOR BUSINESS BUT THAT
IN THE PROCESS OF HAMMERING OUT THE FINAL PROGRAM HAD
TO CEDE TO THEIR SPD COALITION PARTNERS WHO FELT THAT
SUCH A MEASURE WOULD BE JUST TOO MUCH FOR THE RANK AND
FILE TO SWALLOW, ESPECIALLY CONSIDERING THE CONTENTS
OF THE REST OF THE PACKAGE. ON THE OTHER HAND, OUR
CONTACT FURTHER STATED THAT HE HAD ADVISED HIS MINISTER
TO OPPOSE THE INCREASE IN THE CONTRIBUTIONS TO THE
UNEMPLOYMENT INSURANCE SYSTEM, AND THAT HE THOUGHT
THAT HIS MINISTER HAD PROBABLY MAINTAINED THIS VIEW IN
THE MINISTERIAL NEGOTIATING SESSION ON THIS TOPIC AT
THE BRAHMSEE. HIS ALTERNATIVE WAS A ONE PERCENT
INCREASE IN THE INCOME TAX, WHICH HE CONSIDERED A MORE
EQUITABLE APPROACH, SINCE PUBLIC SERVANTS AND OTHERS DO
NOT CONTRIBUTE TO THE UNEMPLOYMENT INSURANCE PLAN, AND
WHICH WOULD HAVE YIELDED THE SAME AMOUNT OF ADDITIONAL
REVENUE. WHETHER THE LOSS OF THIS POINT WAS AN
OFFSET TO THE FDP'S LOSS ON ITS BUSINESS TAX CUT
PROPOSAL, IS UNCLEAR. WHAT IS CLEAR IS THAT THERE
IS AN INCREASING INDICATION OF SPLITS IN THE VIEWS OF TH
COALITION PARTNERS REGARDING THE BEST WAY TO DEAL WITH
MEDIUM-TERM ECONOMIC/FISCAL PROBLEMS. FURTHERMORE,
THE FINANCE MINISTRY OFFICIAL WHO SPOKE WITH US SAID

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AMCONSUL BREMEN
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THAT THERE WERE ALSO SPLITS WITHIN EACH OF THE TWO
COALITION PARTIES ON THE SAME ISSUES. HE FELT THAT
OVER THE COURSE OF TIME A COMPROMISE SOLUTION WOULD,
HOWEVER, BE ARRIVED AT ON THOSE ISSUES WHERE DIVISION
EXISTED, NOT ONLY WITHIN THE PARTIES, WHERE HE EXPECTED
DISCIPLINE WOULD BE MAINTAINED IN THE FINAL ANALYSIS,
BUT ALSO AS BETWEEN THE COALITION PARTNERS. HE
ADMITTED THAT THE VAT INCREASE PROPOSAL WAS IN TROUBLE,
BUT WOULD NOT DECLARE IT A LOST CAUSE. (OUR SOURCE IS
BY NATURE AN OVERLY CONFIDENT PERSON.) ON THE OTHER
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HAND, HE INTIMATED THERE MIGHT BE SOME GIVE POSSIBLE
ON THIS SINCE THE MEDIUM-TERM PROJECTIONS INCLUDING THE
TAX INCREASE YIELDED REVENUES SO EMBARRASSINGLY HIGH
(BUT STILL YIELDING A PROJECTED SIZABLE DEFICIT) THAT
THE STATES WERE CLAMORING FOR AN INCREASED SHARE OF THE

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NEW TAKE THAT IF HEEDED WOULD GREATLY DIMINISH ITS EFFECTIVENESS TO THE FEDERAL LEVEL ANYWAY.

9. COMMENT:

A. A TAX INCREASE HAS LONG BEEN TALKED ABOUT AS AN INEVITABLE EVENTUAL STEP BY THOSE WHO BOTHERED TO LOOK BEYOND THE IMMEDIATE FUTURE (SEE EMBTEL 8375). HOWEVER, IT WAS GENERALLY EXPECTED THAT ITS PROPOSAL BY THE GOVERNMENT WOULD BE POSTPONED TO A POLITICALLY MORE CONVENIENT TIME GIVEN THE FALL 1976 PARLIAMENTARY ELECTIONS. WHY (APPARENTLY UNNECESSARILY) TOUCH SUCH A SENSITIVE NERVE THIS FAR IN ADVANCE OF PLANNED IMPLEMENTATION AND WHEN THE CURRENT BUSINESS CYCLE SITUATION PRACTICALLY ASSURES AN UNFRIENDLY RECEPTION? THIS WAS, HOWEVER, PERHAPS CONSIDERED THE BEST DEFENSE AGAINST OPPOSITION CHARGES OF FISCAL IRRESPONSIBILITY AND THEREBY DEFUSE EARLY AN ISSUE THAT COULD ALSO BLOSSOM INTO A LIABILITY COME ELECTION TIME. AND, IF THE OPPOSITION BLOCKS PASSAGE OF THE LEGISLATION, WHO COULD THEN BE BLAMED AS BEING FISCALLY IRRESPONSIBLE?

B. IN THE SAME WAY THIS APPROACH MIGHT FORESTALL THE POTENTIALLY TROUBLESOME PROBLEM THAT WOULD LOOM IN 1977 WHEN THE DEBT-LIMITING FEATURES OF ARTICLE 115 OF THE CONSTITUTION COULD PROBABLY NO LONGER BE AVOIDED DUE TO THE RETURN TO THE NORMAL ECONOMIC GROWTH AND EMPLOYMENT CONDITIONS THAT LIKELY WILL EXIST AT THAT TIME. THE TAX INCREASE WOULD PERMIT GETTING IN JUST UNDER THE DEBT LIMIT LINE. WITHOUT IT, THE LINE WOULD BE EXCEEDED BY A CONSIDERABLE MARGIN EVEN USING THE OPTIMISTIC GOVERNMENT ECONOMIC GROWTH FORECAST. IF THE OPPOSITION BLOCKS THE TAX INCREASE, THEY WOULD BE IN A POOR POSITION ALSO TO BLOCK IN 1977 WHAT LOOKS LIKE THE OTHERWISE NECESSARY REVISION TO THE LAW TO PERMIT A RAISING OF THE DEBT
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